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DOW THEORY LETTERS

"THE MARKET AS INTERPRETED UNDER THE DOW THEORY"

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THIRD PHASE. The third phase of a bull market may last a few months to a few years. In some bull markets such as those of 1932-37 and 1942-46 the three phases were not all separated by secondary reactions. In others such as the present one all three phases were clearly delineated by secondaries. Third phases are characterized by widespread public participation, rampant speculation, excessive volume, and great advances in most groups of stocks, not the least of which are the low-priced "cats-and-dogs". In fact it is only during the third or final phase that the "dogs" make their tremendous moves.

COMPARISONS. No two bull markets are exactly alike. In their general structure, however, they follow remarkably similar patterns. For this reason comparisons are valuable. Volume of trading is now running at the same clip as early 1928. Low-priced stocks as measured by Standard & Poor's Index are at 68 as compared to about 35 in 1928 when the D-J Averages were in the 200 area. In 1928 a record 24-week advance carried industrials from 201.96 in June to 295.62 in November for a gain of 93.66 points or 46%. A secondary then wiped out 40.0% of the entire preceding swing, returning the industrials to 257.33.

The present 175 point swing has taken industrials about 42% above their October, 1957 lows without a single secondary reaction. This advance has been consolidated through many "lines" and minor declines; it has lasted about 15 months. The only precedents in the history of the averages are the 1928 swing and the fabulous 1953-56 advance which took industrials from 255.49 in September, 1953 to 521.05 in March, 1956. During that period two mild secondaries, one of 33 points (Eisenhower heart-attack) in September, 1955, and one of 26 points in January, 1956, corrected the advance.

SECONDARIES. Secondaries occur when the market is overbought and technically weak or when it is anticipating a future recession in business. It remains to be seen whether this present advance can continue much further without a reaction. Sooner or later every bull swing in history has been corrected; it is mainly a matter of when. I note that the financial writers and investment services, having been so wrong to date in their predictions of a reaction, are now playing safe and are reluctant to suggest that possibility in public. This single fact has caused me to be more wary than perhaps any other. The market seldom acts over a period of time in the manner prescribed for it. By all reports we are now to have a straight-line advance to the mid-600 area on the industrial average. This may prove to be the trend of events, but this writer nevertheless took some profits last week. If stocks continue to advance the remainder of my portfolio should do handsomely; if a reaction does come I will add to my lines on the first buy-spot.

GREED. The Dow Theory never was a device for milking the last dollar out of the market. Nor is it a system which can make money for its followers at any given time. Great buy and sell areas come seldom; the Theory is not interested in the fact that we may have money to invest today. We can enter the market near the bottom with the aid of the Theory, and it can help us to get out nearer the top than the middle. I am aware that there are many other systems which claim to be able to capture 95% of the swing. This writer, however, has never made a nickel with any of them, so he must be content with the profits he can safely gather on Dow Theory trading. This means staying with perhaps 60-80% of the swing whereas other investors may be smart enough or lucky enough to swallow the whole goose.

TOPS AND BOTTOMS. It is invariably easier to call the bottom of a move than the top. There are many excellent indications with which to judge a market after it hits its

reaction lows; it is extremely difficult to call a top, however, and almost impossible to call the exact top. For this reason many Dow Theorists sell after a long advance, particularly when the averages begin to flash danger signals. They prefer to take their profits and wait patiently on the sidelines for the next buying opportunity. A difficult problem near the highs is that not all danger signals prove to be valid. Often a day of bearish volume indications or perhaps diverging price movements (the two averages moving in opposite directions) may warn of danger; then these warnings prove deceptive and the market soon continues on its bullish course. Dow Theorists must content themselves with the old adage which says "the market will be there tomorrow".

VALID SIGNALS. I want to emphasize again that the higher this market goes the less valid each bullish signal (penetration of the previous high points by each average) becomes. Eventually we will receive a bullish signal predicting higher prices, and soon afterwards a secondary reaction will occur. Or finally, following a bullish signal, a bear market will commence. Critics of the Dow Theory will then announce that the Theory does not work. They will disregard the many bullish signals throughout the entire market that did predict higher prices and point an accusing finger at the one that did not.

The Dow Theory concerns itself with much more than mere penetration of previous points. Duration, timing, extent, and phases are involved. After a bull swing of 42% and 175 points on the industrials, we become less prone to buy on the advent of bullish penetrations of previous highs. I am now 175 points less bullish than I was in November, 1957, and if this advance continues I will become increasingly less bullish, regardless of penetrations.

CONFIRMATION. One of the most dangerous practices is to follow the indications of one average while ignoring the other. Most investors watch only the industrials and this proves their eventual downfall. At the start of a great many secondary reactions, following the first dip one average advances, often to new highs but unaccompanied by the other average. During this final thrust (usually on decreasing volume) the weaker average is being distributed under the disguise of deceptive strength in the other. Traders, sensing the technical weakness, seize this period as an opportunity to unload securities. The market, which is literally poised on "tip-toe" in a show of abortive strength, soon sells off under the weight of new offerings.

BUY? Many new subscribers and a few older ones are now asking, "Should I buy stocks?" My only answer is that I simply do not know. Robert Rhea, in my opinion the greatest of all traders, once said that "While there are rare times when I feel absolutely confident of a position, about 80% of my own days are spent in perplexity". Rhea was an honest man. This writer was begging people to buy stocks in early 1958, but after a 42% advance in industrials I cannot in all honesty advocate plunging into the market. Stocks should have been bought a year ago when every indicator was fairly shouting "buy". These letters teach people the implications of the market as interpreted under the Dow Theory. There is nothing in the Theory that in the wildest stretches of the imagination ever implied committing all one's new funds to stocks after industrials have had an uncorrected advance of 176 points. The market may climb another 42% but this writer will not become more bullish during the move.

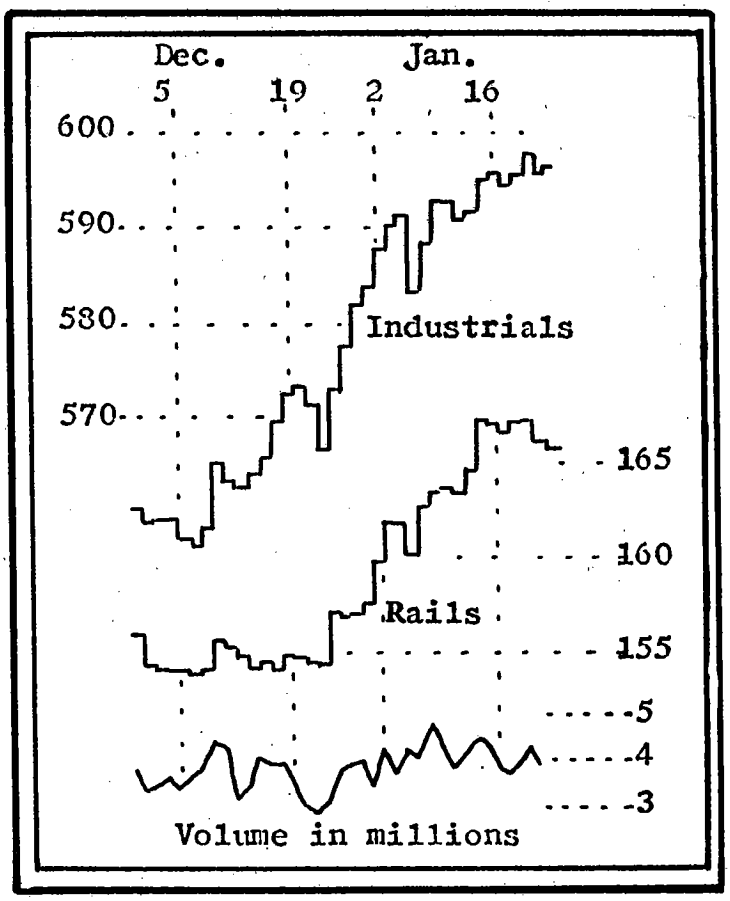
PRICE MOVEMENTS. Last week as the industrials approached the 600 area for the first time in history the market showed signs of caution and hesitancy. The new industrial highs of Thursday and Friday were unconfirmed by the rails and are therefore useless and perhaps deceptive as far as the Dow Theory is concerned. The averages diverged on Monday and Friday and on Thursday volume increased as prices declined. The indications of a single day do not give us a reliable prediction, but three such signs together with an unconfirmed high portray general uncertainty.

Three things can now happen. The two averages may go through their respective highs (industrials 597.66; rails 167.38) for a bullish prediction of further price increases. The two averages could turn down in a zig-zag pattern and a decline or secondary reaction of indeterminate proportions could develop. The first meaningful downside check point would be the decline lows (industrials 583.15; rails 160.10) of a few weeks ago. If the dual indicators broke these two points it could be the beginning of something dangerous. Remember that a penetration of one average unconfirmed by the other is meaningless and often deceptive. The third possibility is that a line could develop. A line is a formation where the two averages fluctuate within a 5% area for a period of two weeks or longer. Joint penetration of a line through the top is a prediction of higher prices to come, and joint penetration downside is a prediction of lower prices. I would guess that if a line does develop it might well be bounded by the lows of 583.15 (industrials) and 160.10 (rails) previously mentioned, and obviously the highs of 597.66 and 167.38 which are also the highs for this entire swing.

Often when a real resistance area such as 600 on the industrials appears, a line will form just under the resistance point. It would not be surprising therefore to see a line form here. In the advent of such a formation the proper procedure would be to wait for a joint penetration before acting. Lines have much more force on a breakout than ordinary penetrations, and this is particularly true of simultaneous penetration (on the same day).

A NEW IMPULSE. The averages are composed of representative stocks that measure the relative strength or weakness of the market. All the knowledge available to anybody who has any interest in business or finance is registered in the two indicators. Each investor, basing his decisions upon what he knows of his own business and the economy, will buy or sell securities as he sees fit. These transactions form a pattern which we attempt to interpret under the Dow Theory. In an area such as this one it is very evident that the market is sifting all the obtainable evidence in order to render its next verdict. The recent hesitancy suggests that the averages are searching for an important new impulse. It is this impulse that we now await.

STOCKS. Picking stocks at these levels is becoming increasingly difficult. They should be purchased on buy-spots as outlined in former letters or less desirably on a bullish signal as described in this letter. The following look bullish on my charts; BALTIMORE & OHIO R.R., MONTSANTO CHEMICAL, DOW CHEMICAL, DIAMOND ALKALAI, Low priced stocks that should do well on a breakthrough are SCURRY RAINBOW, JUPITER OILS, FARGO OILS, HUPP, LEHIGH VALLEY INDUSTRIES, CALLAHAN MINING, STUDEBAKER PACKARD. These could outperform the market if the third phase started boiling and might hold up quite well in a reaction.



Thirty Stocks Used in Dow Jones Industrial Averages are:		
Allied Chemical	General Electric	Procter & Gamble
Amer Can	General Foods	Sears Roebuck
Am Smelt& Ref	General Motors	Std Oil of Cal
Amer Tel & Tel	Goodyear	St Oil of N J
Am Tobacco	Inter Harvester	Texas Co.
Bethlehem Steel	Inter Nickel	Union Carbide
Chrysler	Inter Paper	United Aircraft
Corn Products	Johns Manville	U.S. Steel
Du Pont	Nat'l Distillers	Westinghouse El
Eastman Kodak	Nat'l Steel	Woolworth
Twenty Railroad Stocks Used are:		
Atchison	Erie	NY NH & H
Atl Coast Line	Great North Ry	Norfolk & West'n
Baltimore & Ohio	Illinois Central	Pennsylvania
Canadian Pacific	Kansas City So	Southern Pacific
Ches & Ohio	Louisv & Nash	Southern Railway
Chi Rk Is & Pac	N Y Central	Union Pacific
Del & Hudson	N Y C & St L	